II. INTRODUCTION

BACKGROUND

Snavely, King & Associates,Inc. ("SKA") was retained by the Georgia Public Service Commission ("GPSC"), to perform an audit of the cost allocations and affiliate transactions of the Southern Bell Telephone and Telegraph Company ("Southern Bell", "SB" or "the Company") from 1988 to 1991. The SK&A auditors worked under the direction of Don Craig, Audit Manager of the GPSC.

This audit represents one element in a series of initiatives taken by the Commission to ensure the appropriateness of intrastate revenue requirements as they could be affected by regulated versus non-regulated cost allocations and affiliate transactions. Concurrent with the Commission's December, 1990 adoption of an experimental incentive regulation plan ("IRP") for the Company, the Commission initiated an effort to design a mechanism that will safeguard ratepayers against problems of improper charging of expenses and cross-subsidization. This effort resulted in the development of an extensive record in Docket 3897-U on the subject of cross-subsidy and cost allocations. The Commission has specifically addressed one of the Company's enhanced services, MemoryCall®, in Docket 4000-U, and it has addressed Open Network Architecture in Docket 4018-U.

On premise review of Company records and operations was conducted by the auditors between July 1992 and April 1994. Field review was supplemented by nearly 300 formal audit requests and numerous informal telephone discussions. Audit results were discussed with Company representatives throughout the audit, and written preliminary audit findings were provided to the Company between February and May 1994. The Company provided the auditors with written responses, and clarifying discussions were held prior to the finalization of all findings. Draft copies of the findings in this report were provided to the Company in August 1994. The Company's written Responses on these drafts comprise Part V of this report.

SCOPE AND OBJECTIVES OF AUDIT

The GPSC defined the scope and objectives of this audit in its Request for Proposals ("RFP") dated May 19, 1992, as follows:

> The scope of this audit will be limited to a review and evaluation of Southern Bell's compliance with this COMMISSION's rule 515-3-1-.10[1] as it pertains to the allocation of costs between its regulated services and non-regulated activities and to recording transactions with its non-regulated affiliates on the Company's regulated books of account for the years 1988, 1989, 1990, and 1991. Specifically, Sections 32.27[2] and 64.901[3] of the Federal Communications COMMISSION's rules.
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> Objectives
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> (1) to have a review of the relationship between the Company's regulated telephone operations and its non-regulated activities and the non-regulated operations of its affiliates;

[1]This rule requires telephone companies to follow FCC rules governing cost allocations and affiliate transactions.

[2]FCC affiliate transaction rules.

[3]FCC cost allocation rules.

(2) to learn whether as a result of these relationships Southern Bell's regulated customers are protected from cross-subsidy, the regulated operations are receiving adequate support and the level of charges from the affiliates are reasonable taking into account the appropriateness of the methods of allocation;

(3) to learn whether or not opportunities exist in these organizational and operating relationships for realizing reductions in operating expense or for increasing operating revenue;

(4) to get quantification of the achievable savings associated with reduced operating expenses or increased revenues and any possible adverse effects associated with these savings;

(5) to receive recommendations for instituting the changes necessary to achieve those savings or improvement;

(6) to have a special review within the scope of the affiliate transaction rules of the purchasing, supply and warehousing function provided by non-regulated affiliates to the regulated operations in Georgia, including a review of the independent auditor's workpapers in regard to the attest audit of the BellSouth cost allocation manual for the years 1988, 1989, 1990 and 1991;

(7) to learn whether or not inflated costs were recorded in Georgia's regulated books for the purchasing, supply and warehousing functions provided by non-regulated affiliates;

(8) to receive a report of all instances of non-compliance with this COMMISSION's rules concerning transactions with affiliates (FCC-Section 32.27), allocation of costs between regulated services and non-regulated activities (FCC - Section 64.901) and all indications or instances of illegal acts that could result in criminal prosecutions (these may be reported separately).

The Federal Communications Commission ("FCC") requires major local exchange carriers to file and maintain a Cost Allocation Manual ("CAM") providing descriptive information regarding their allocation of costs between regulated and nonregulated activities.[4] The FCC also requires each carrier filing a CAM to have an independent auditor verify each year that its regulated reports are fairly presented in accordance with the CAM and other FCC regulations.[5]

During the period of the audit, Southern Bell was subject to the CAM filed by its parent, the BellSouth Corporation ("BSC"). The auditors were given access to the CAM workpapers and reports of BSC's independent auditor, Coopers & Lybrand ("C&L"), at the outset of their work. The auditors also reviewed related internal audits performed by Company personnel.

The auditors review of C&L's workpapers and internal audits provided them with a basis for focusing their efforts in an efficient manner. The auditors were thus able to avoid redundant review of areas routinely audited, and concentrate on aspects of the Company's operations which receive less critical attention.

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[4]Code of Federal Regulations, Title 47, §64.903.

[5]Id., §64.904.

SOUTHERN BELL BACKGROUND

During the audit period, Southern Bell was a regulated carrier providing a variety of local exchange and interexchange services to more than 8.5 million customers in areas of Florida, Georgia, North Carolina and South Carolina. Southern Bell's parent, BSC, was also the parent corporation of the South Central Bell Telephone Company ("SCB"), another regulated carrier, and various nonregulated subsidiaries engaged in business other than the provision of regulated local exchange service.

During the audit period, SB and SCB jointly owned BellSouth Services ("BSS"), which provided services on a centralized basis. Effective January 1, 1992, SB, SCB and BSS were merged into a new regulated carrier, BellSouth Telecommunications ("BST"). Detailed organization charts covering the audit period from the BSC Cost Allocation Manual ("CAM") appear in Appendix B.

1. **<u>The special tax benefits of the Company's Leveraged Employee Stock Ownership Plan should flow to regulated operations.</u>**

<u>Summary</u>

BellSouth Corporation is obtaining a subsidy by allocating leveraged employee stock ownership plan ("LESOP") costs to regulated operations while retaining the related tax advantages at the Corporate level. Although BellSouth Corporation allocates a majority of LESOP costs to its regulated subsidiaries, it retains all of the special tax advantages associated with LESOP Trust stock dividends at the nonregulated corporate level. This is a mismatch of costs and benefits. The Georgia intrastate portion of these tax benefits for the 1990 - 1994 period is estimated to be $6.1 million. The Georgia Surveillance report should be adjusted to flow LESOP tax benefits to regulated operations.

<u>Criteria</u>

The audit objective in this area was to determine if the nonregulated corporate parent, BSC, is obtaining a subsidy by allocating LESOP costs to regulated operations while retaining associated tax advantages at the corporate level. This evaluation included an analysis of the basic LESOP Trust's stock purchases, the economic assumptions used by the Company to evaluate the initial LESOP plan, subsequent stock performance, interest on LESOP notes, tax savings associated with LESOP stock dividends and the additional allocation of cost associated with the plan to Georgia.

Condition

In 1990 the Company implemented a leveraged employee stock ownership plan (LESOP). The plan revolves around a trust. The trust borrowed $850 million and purchased an equivalent amount of BSC common stock to be used in the future as an employee savings plan benefit. As employees place money into a savings plan, the trust provides matching contributions at specified percentages in the form of BSC stock. The LESOP plan was approved and implemented under the assumption that the growth in stock price and dividends associated with the purchased shares would reduce BellSouth's overall cost of providing benefits to its employees.[6]

The interest and principal on the loan taken to purchase BSC stock is charged to the operating companies as a "Benefit expense" and recorded above-the-line as operating expense. Any market loss on the value of the original stock purchases is also charged to the operating companies and their regulated customers as an operating

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[6]Thus far this has not been the case. The plan will cost Georgia's regulated customers about $24.4 million ($18.3 million intrastate) in increased benefit expense above what would have been charged had the plan not been implemented for the 1990-1994 period. The plan's economic evaluation anticipated that BellSouth's stock prices would increase at a rate of 6.5 percent per year. One of the Company's LESOP Plan assumptions was that the 1991 stock price would be $59.50. This assumption leads to a forecasted stock price of $63.37 and $67.52 for 1992 and 1993 respectively at the 6.5 percent assumed growth rate. The actual 1991 average stock price was only $49.80, while the 1992 average stock price was $53.70. BellSouth's 1993 end-of-year stock price was approximately $58.00 per share, which is about 20 percent less than what was anticipated in the plan's economic evaluation.

The anticipated increase in BellSouth's stock price was intended to off-set the interest expense resulting from the $850 million loan. In reality, stock prices fell rather than increased. Consequently, the LESOP increased employee benefit expenses rather than reducing them.

expense. Finally, any other increased costs are charged to the regulated operating companies as benefit expenses. Dividends received by the trust on the BSC common stock are netted against the benefit expenses charged to the operating companies.[7] BSC receives a special tax deduction for the dividends it pays to the trust.

The audit determined that BSC is retaining, at the corporate level, the special tax deductions associated with dividends on the stock purchased by the LESOP trust, while allocating trust expenses to Georgia's customers as part of BSC's allocation of employee benefit expense.

Although the LESOP was designed to provide benefits for 13 years, the Company only provided LESOP estimates of cost, dividends and tax information through 1994. This became the basis for a five year audit evaluation. (See Appendix C).

Effect

The tax savings associated with Georgia's portion of the dividend deduction being retained at BellSouth for the 1990-1994 period is $8.1 million dollars ($6.1 million intrastate).

Cause

Retaining LESOP dividend tax savings at BSC, while allocating LESOP expenses to the individual companies, was a corporate

[7] The annual interest alone is approximately $30 million more than the dividends received by the trust.

decision.

Recommendation

The auditors recommend that the tax savings associated with LESOP stock dividends be included as an adjustment to Georgia's Net Operating Income ("NOI") as reported on the Georgia Surveillance Report. A one time NOI adjustment of $6.1 million should be included in Georgia's Surveillance Report to reflect Georgia's intrastate portion of the 1990-1994 tax savings. Also, an ongoing NOI adjustment of at least $1.2 million should be made each year. An alternative to an annual $1.2 million adjustment would be to require the Company to incorporate an adjustment comparable to the appropriate LESOP dividend tax deduction in future Georgia regulated tax calculations.

This audit recommendation is based on the premise that if regulated customers are required to provide revenue to cover all of the cost for their portion of the LESOP Plan, then those same customers should share in any off-setting tax benefits available because of the plan. It is important to note that the auditors are not proposing to exclude any LESOP expenses from the ratemaking process, but that we strongly recommend that all tax savings associated with the plan be used to reduce the expense of the plan whenever possible. The Company's position is that it should retain the tax advantage of the plan because BSC "signed" for the LESOP Loan from Morgan Stanley, although the local Operating Telephone Company ("OTC") must assume the risks and costs associated with the loan and value of the stock purchased. The OTC is obligated to compensate BellSouth for all employee benefit expense assigned (including interest on the loan and loss in stock value). Southern Bell's management does not have the option of not paying BSC for any expense assigned, as BSC is the "owner" of Southern Bell and South Central Bell, and dictates policy. The Company's position relating to the loan liability and retention of the tax savings has no merit.

Finally, the Company claims that GAAP requires that the nonregulated parent retain the tax benefit. GAAP does not control ratemaking and should not be used as a justification for mismatching costs and benefits between nonregulated and regulated operations.

2. **The Company has achieved a significant cross-subsidy from its regulated operations and BAPCO to its nonregulated operations as a result of its filing of consolidated tax returns. The cumulative tax savings should be deducted from the Company's rate base.**

Summary

Southern Bell is a signatory to an agreement under which it charges income taxes to its regulated operations at a rate that exceeds the actual tax rate of the consolidated group of which it is a member. Resulting excess taxes are transferred through the corporate parent to unprofitable affiliates which are also members of the consolidated group. These transfers, which are actual cash payments from the regulated operations to the nonregulated operations, help finance the losses of BSC's nonregulated operations. If nonregulated operations eventually become profitable, future taxes will be paid out of future revenues without any recognition of the fact that regulated operations helped finance early losses. If nonregulated operations remain unprofitable, regulated operations will continue to finance their losses until the unprofitable operations are discontinued. In either case, there is a significant cross-subsidy from regulated operations to nonregulated operations. The auditors recommend that Georgia's share of the cumulative tax savings resulting from the filing of consolidated tax returns back through 1984 be deducted from Southern Bell - Georgia's rate base.

Criteria

One of the objectives of this audit was to learn whether, as a result of the relationship between the Company's regulated telephone operations and the nonregulated operations of its affiliates, Southern Bell's regulated customers are protected from cross-subsidy. The Commission has defined cross-subsidy as any action undertaken by SBT which results in an understatement of intrastate regulated revenues or an overstatement of intrastate regulated expenses or investment for SBT.[8]

Condition

The auditors identified a tax deduction associated with the Company's leveraged employee stock ownership plan ("LESOP") being taken by BSC which was not being shared with regulated subsidiaries such as Southern Bell. The regulated operations in Géorgia received no benefit from this tax deduction even though they absorbed the cost of the LESOP.[9] The auditors also identified a situation in which the company obtained an interest income benefit which was taken below-the-line even though a portion of the related cost was recorded above-the-line as an accumulated deferred tax debit. Consequently, the auditors determined that it would be appropriate to compare and attempt to reconcile the parent company's Federal income tax return to the Georgia Federal income

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[8]Docket No. 3987-U.

[9]The LESOP is the subject of Finding No. 1.

tax return.[10]

During the course of the attempted reconciliation the auditors were informed that profitable subsidiaries such as Southern Bell pay their tax liabilities to BSC, but BSC does not pay all of these funds to the Federal government. A portion of the funds collected from the profitable subsidiaries is distributed to unprofitable subsidiaries.

BSC files a consolidated Federal tax return. Its eligible subsidiaries include Southern Bell, South Central Bell, BSS, BAPCO and other nonregulated and international subsidiaries. These companies signed an agreement titled "Consolidated Federal Income Tax Allocation Policy ("CFITAP") under which each company computes its annual Federal income tax expense on a "stand-alone" basis as if it were not a member of an affiliated group filing a consolidated tax return. BSC collects the stand-alone taxes from its profitable subsidiaries and transfers a portion of the funds to its unprofitable subsidiaries as described above. The taxes distributed to the unprofitable subsidiaries are not, and never will be, payable to the government. BSC's first consolidated Federal tax return was its 1984 return.

In the context of this finding, it is important to understand the relationship of Southern Bell to BAPCO since BAPCOs tax expense has an impact on Southern Bell of Georgia's intrastate regulated net income.

BAPCO is a nonregulated affiliate treated as regulated in

[10]This reconciliation is the subject of Finding No. 3.

Georgia. Under the terms of an agreement between Southern Bell and BAPCO, Southern Bell receives a significant portion of BAPCO's revenues. The agreement provides for a 45.26 percent revenue sharing factor (publishing fee) from BAPCO to Southern Bell. These revenues are included in Southern Bell - Georgia's regulated earnings. The Georgia PSC requires additional imputations that result in a BAPCO publishing fee of 50 percent (instead of 45.26 percent) and an imputation of 50 percent of BAPCO's income over a 10.15 percent Return on Investment.

These additional imputations are done monthly and adjustments are made to the Georgia Surveillance Report. The imputation of 50 percent of BAPCO income over 10.15 percent is measured after taxes. Consequently, BAPCO's income tax expense is treated as regulated cost and has an impact on Georgia's regulated net income. The higher BAPCOs income tax expense, the lower Southern Bell - Georgia's regulated net income. Since BAPCO is a signatory to the CFITAP, it's income taxes are also computed on a stand-alone basis and therefore subject to transfer to unprofitable operations.

The audit period tax liability summary below is based on individual annual summaries provided by the Company.

BellSouth Corporation and Subsidiaries
Tax Liability Summary
1988 to 1991 [11]
($000,000)

	Description	Amount
1.	Tax Liability of Bell South Services	$ 48 [12]
2.	Tax Liability of South Central Bell	1,315
3.	Tax Liability of Southern Bell	1,650
4.	Tax Liability of Other Profitable Operations [13]	350 [14]
5.	Tax Liability of Nonregulated Loss Operations	(280) [15]
6.	Total	$3,083
7.	Taxes Collected by BSC (L1 to L4)	3,363
8.	Tax Distributions to Loss Operations	(280) [16]
9.	Tax Liability to Government	$3,083

This tax liability summary demonstrates that $280 million of taxes were collected from profitable operations and distributed to unprofitable affiliates during the 1988 to 1991 audit period. The revenue requirement effect of the $280 million tax distribution is $424 million at a 34 percent tax rate ($280/.66 = $424). The auditors estimate that $44.7 million of the $280 million distribution is attributable to Southern Bell - Georgia. This would equate to a $67.7 million revenue requirement at a 34 percent

[11] Item No. MJM-29, Supplement.

[12] Company treats BellSouth Services as regulated, for the purpose of this summary.

[13] Includes BAPCO and other nonregulated operations.

[14] By subtraction based on the $280 on line 5.

[15] Summary level number based on February 10, 1994 interview with Company personnel. Proprietary figures were shown to auditors and then withdrawn.

[16] Summary level number based on February 10, 1994 interview with Company personnel. Proprietary figures were shown to auditors and then withdrawn.

tax rate.

The Company asserts that the $44.7 million amount attributed to Georgia is "grossly overestimated since it was based on total nonregulated losses for the entire period 1988 to 1991". The tax liability summary above indicates that the positive tax liabilities of the Other Profitable Operations (line 4) exceed the negative tax liabilities of the Nonregulated Loss Operations (line 5). However, the Other Profitable Operations figure includes BAPCO, whose earnings are treated as regulated in Georgia. The auditors requested, but were denied, access to the BAPCO tax liability numbers and thus are unable to determine the portion of the $350 million tax liability of Other Income Operations which is attributable to BAPCO.

The table below shows the annual net tax liabilities of BSC's nonregulated operations for the 1988 to 1991 audit period. As explained above these amounts include BAPCO results even though BAPCO is treated as regulated in Georgia.

Annual Net Tax Liability
of Other Profitable Operations
and Nonregulated Loss Operations
1988 - 1991
($000,000)

Year	Amount
1988	($17.6)
1989	35.3
1990	12.7
1991	40.2

The first year (1988), shows a negative amount, which means that, even with the inclusion of BAPCO in nonregulated operations, losses exceeded profits. The auditors were informed that in 1991 the Cellular operation became profitable, but that does not account for the significant turnaround in 1989. Since the auditors were denied access to financial information concerning any nonregulated affiliate, they can only speculate as to the cause of the 1989 turnaround.

The 1989 turnaround appears to have resulted from the Company's reintegration of Advanced Systems Inc.'s CPE line of business back into Southern Bell as a nonregulated line of business. CPE, as explained in Finding Nos. 3 and 12, was an unprofitable operation. Hence, the reintegration of the CPE business into the regulated companies would have increased the collective net profit of the nonregulated affiliates. It also appears that a majority, if not all, of the nonregulated profits in the years 1990 and before (i.e. back to 1984) were provided by BAPCO. Thus, for the period 1984 to 1990 BSC's regulated operations and BAPCO financed the losses of all of BSC's nonregulated affiliates (including the Cellular operation) through the transfer of tax funds collected under the terms of the CFITAP.

The estimates discussed in the finding have been made at a summary level because the information provided by the Company was at a summary level. No specific tax information relating to any of BSC's nonregulated subsidiaries, including BAPCO, was provided. The summary information upon which these estimates were based was only shown to the auditors one time. It was not, like certain other proprietary information, retained in a room available for additional review, although the Company has offered to make it available for further review upon request. BSC would not release proprietary information to the possession of BellSouth Telecommunications even under the terms of a proprietary agreement.

Effect

The stand-alone tax calculations and the Company's CFITAP resulted in a significant cross-subsidy from profitable regulated operations and BAPCO to unprofitable nonregulated operations. Beginning in 1984, funds provided by regulated operations were transferred to nonregulated operations. Consequently, the initial losses of all nonregulated subsidiaries, whether they subsequently became profitable or not, were subsidized by regulated operations.

The amount of the subsidy prior to the audit period was not available to the auditors. During the 1988 to 1991 audit period the subsidy was $280 million at the BSC level and $44.7 at the SB-Ga. level.[17] The equivalent revenue requirement effects at a 34 percent tax rate are $424 million and $67.7 million respectively. The subsidy extending back to 1984 is undoubtedly much larger.

Although the Company does not dispute the fact that tax funds were and continue to be transferred from profitable to unprofitable subsidiaries, it disagrees conceptually that the stand-alone tax calculations and CFITAP resulted in a subsidy from regulated to nonregulated operations.

The Company believes that if any recognition is given by the

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[17]

$280.0	100%	BSC
154.0	55%	SBT
44.7	29%	SBT - Ga.

regulated operations to the transfer of tax funds to nonregulated operations this would produce a subsidy to the regulated operations from the nonregulated operations. The auditors disagree. This is a matter of substance over form. The substance of the transaction is that the cash flows from regulated operations to nonregulated operations.

The table below provides an example of the cross-subsidy from regulated to nonregulated resulting from the use of the stand-alone tax calculation combined with consolidated tax returns under the terms of BSC's CFITAP. It is based on an example provided by the Company and utilizes a 35 percent tax rate.

Example of Subsidy
Resulting From Stand-Alone Tax Calculations
and Consolidated Tax Returns

Year 1

	Stand-Alone		
	Regulated	Nonregulated	Consolidated
Taxable Income	$ 35,000	$(10,000)	$ 25,000
Tax Liability at 35%	12,250	0	8,750
Cash Transferred to Nonregulated[18]	(3,500)	3,500	-
Tax Paid to Government	$(8,750)	0	$(8,750)

Year 2

	Stand-Alone		
	Regulated	Nonregulated	Consolidated
Taxable Income	$ 35,000	$ 10,000	$ 45,000
Tax Liability at 35%	12,250	3,500	15,750
Cash Transferred to Nonregulated	0	0	0
Tax Paid to Government	$(12,250)	$(3,500)	$(15,750)

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[18] Subsidy

The cross-subsidy occurs in the first year when the nonregulated subsidiary loses $10,000. Cash of $3,500 is transferred from the regulated operations to the nonregulated operations thus subsidizing the loss. In the second year, when the nonregulated operation becomes profitable, it pays taxes out of its own income to the government.

Under the terms of the CFITAP combined with stand-alone tax calculations, the regulated operations subsidize a portion of the initial losses by being charged with overstated taxes and then distributing the excess amount to the unprofitable affiliates. The subsidy is permanent since any future tax expenses will be paid out of the affiliate's future earnings if it becomes profitable. However, if the nonregulated affiliate becomes profitable, none of the nonregulated profits are assigned to the regulated operations. Regulated operations will have financed early losses and born a portion of the risk associated with the success of the operation without any share of the profitable outcome. If, on the other hand, the unprofitable subsidiary never becomes profitable, the regulated operations merely continue to finance losses until the unprofitable subsidiary is discontinued. In either case there is a cross-subsidy.

Cause

This cross-subsidy resulted from the Company's decision to adopt a CFITAP requiring stand-alone tax calculations and the distribution of the excess taxes from profitable subsidiaries to unprofitable subsidiaries. As indicated above, this began in 1984. The FCC's Part 32 was initially implemented in 1988. Rule 32.27(e) requires the use of stand-alone tax calculations for carriers who are parties to consolidated tax returns. Therefore, the Company's decision and subsequent strict adherence to FCC Rule 32.27(e) cause the cross-subsidy described in this finding.

Recommendation

The auditors recommend that Southern Bell - Georgia's share of the cumulative net tax savings resulting from BSCs filing of a consolidated tax return be used as a rate base reduction in the Surveillance Report. This calculation should be based on all years from 1984 to date. This will recognize the nonregulated losses which have been subsidized by regulated operations.

As indicated in the finding, amounts prior to the audit period were not made available to the auditors. The Company should be instructed to provide these amounts. The amount for the audit period is $44.7 million. The additional amounts for the four years prior to the audit period and two years subsequent to the audit period will result in a rate base reduction significantly greater than $44.7 million.

On a going-forward basis, the Commission has two available options. First, to recognize the tax losses in the calculation of the Surveillance Report tax expense calculation. Alternatively, the Commission could merely continue accumulating the net tax savings as a rate base reduction. The auditors recommend the latter approach on a going-forward basis.

The recommended approach was initially proposed by the Internal Revenue Service in proposed regulations relating to sections 1.167(1) - 1(a)(7) and 1.268(i)-1 regarding the treatment of consolidated tax savings by public utilities. These proposed regulations were subsequently withdrawn. Nevertheless, it was the IRS's position that such an adjustment would not violate the normalization rules of the Internal Revenue Code, whereas, an adjustment to the tax expense to account for consolidated tax savings would have violated normalization rules. Since these proposed regulations have been withdrawn, the Commission is free to make any adjustment it deems appropriate relating to consolidated tax savings. The auditors believe that the rate base reduction of the cumulative tax savings is the most theoretically correct with respect to past subsidies. A continuation of this approach on a going forward basis would result in a single approach being used for Surveillance Report purposes.

3. **Income tax expense charged to regulated operations should not be used to subsidize the losses of nonregulated products and services offered by Southern Bell Georgia.**

Summary

During the 1988 to 1991 audit period, Southern Bell - Georgia subsidized $19.5 million of losses incurred by its nonregulated lines of business by increasing the taxes charged to its regulated business. The auditors recommend that on a going forward basis, the adjustments to total company and regulated tax expense relating to nonregulated lines of business be limited to subtracting taxes resulting from taxable income - not losses - of nonregulated lines of business. The auditors recommend that the $19.5 million subsidy during the audit period be set up as an accumulated deferred debit, with the corresponding credit to nonregulated taxes. The accumulated deferred tax amount should be deducted from rate base and amortized back into regulated income over a four-year period.

Criteria

Telecommunications companies in Georgia may not use current revenues earned or expenses incurred in conjunction with services subject to regulation to subsidize services which are not regulated or tariffed.[19] One of the objectives of this audit was to learn whether Southern Bell's regulated customers are protected from cross-subsidy. The Commission has defined cross-subsidy as any action undertaken by SBT which results in an understatement of

[19] O.C.G.A. Section 46-2-23(g).

intrastate regulated revenues or an overstatement of intrastate regulated expenses or investment for SBT.[20]

Condition

Southern Bell - Georgia provides both regulated and nonregulated products and services. Our review of the Company's income tax calculation indicates that the Company calculates its Federal tax expense at the total Company - Georgia level including its regulated and nonregulated business, and then makes various adjustments to arrive at the Federal income tax included in the Surveillance Report. When a nonregulated line of business (LOB) is profitable, the total Company - Georgia tax expense includes a positive amount for the income taxes resulting from the profits of the nonregulated LOB. One of the Company's adjustments to arrive at the Surveillance Report tax expense is to subtract the nonregulated income taxes from the total Company tax expense. This is an appropriate adjustment since it represents actual tax expense incurred by the nonregulated LOB which should not be charged to the regulated operations.[21]

When the nonregulated LOB loses money, a negative tax expense amount is included in the total Company tax expense. Consequently, the Company's adjustment discussed above results in an addition to the total Company tax expense when the nonregulated lines of

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[20]Docket No. 3987-U.

[21]Other aspects of the tax calculation for Georgia's regulated operations are addressed elsewhere.

business lose money.[22] The increased amount is charged to the regulated operation's tax expense. However, the funds derived from this increased charge to regulated operations are never paid to the government as taxes, but merely serve to offset the losses of the nonregulated LOB.

The table below provides two examples demonstrating the Company's tax adjustments for its nonregulated operations. Both examples assume that the regulated operations have taxable income of $15,000, and that the Federal Income Tax rate is 35 percent. The first column assumes that the nonregulated LOB had taxable income of $300. The second column assumes that the nonregulated LOB incurred a loss of $3,700.[23]

Example of Company's Income Tax Calculation for Nonregulated Business

Description (A)	Nonregulated Income (B)	Nonregulated Loss (C)
1. Regulated Net Income	$15,000	$15,000
2. Nonregulated Net Income (Loss)	300	(3,700)
3. Total Net Income (L1 + L2)	$15,300	$11,300
4. Tax Rate	35%	35%
5. Total Company Tax Payable to Government (L3 x L4)	$ 5,355	$ 3,955
6. Company Adjustment for Nonregulated (L2 x L4)	105	(1,295)
7. Total Taxes Charged to Regulated (L5 - L6)	$ 5,250	$ 5,250

[22] Mathematically the subtraction of a negative amount results in an addition. This was confirmed by the auditors' review of the Company's calculation of its 1991 Georgia FIT expense. The review indicates the Company added $6,362,148 of taxes associated with nonregulated losses to arrive at the Surveillance Report income tax expense charged to Georgia ratepayers.

[23] These examples are drawn from an example provided by the Company.